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Client Alert

California Responds to Abusive Tax Schemes

Pillsbury Winthrop LLP **Tax Practice Development Team** **July 2003**

California recently has stepped up its efforts to crack down on "abusive" tax shelters, which have been estimated to cost the State of California as much as $1.3 billion annually in lost tax revenue. Abusive tax shelters or schemes generally are defined as transactions promoted for the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. The California Legislature has proposed two bills aimed at discouraging investment in abusive tax schemes and providing the State with more tools to combat tax avoidance behavior. In addition, the California Franchise Tax Board (FTB) and the Internal Revenue Service (IRS) have joined forces in an attempt to end illegal tax shelters. While these current legislative and administrative efforts ostensibly are aimed specifically at illegal tax shelters and abusive schemes, such efforts may impact California corporate taxpayers generally, in both transactional and controversy areas.

Pending Legislation

Two tax shelter bills, S.B. 614 and A.B.1601, are pending before the California Legislature.[1] S.B. 614 mirrors recent federal legislation by broadening reporting and disclosure requirements and imposing greater penalties relating to abusive tax shelter transactions. Specifically, S.B. 614 would:

- Create a regime of penalties and reporting requirements for investors, promoters, tax advisors and tax preparers involved in abusive tax shelter transactions to identify existing abusive tax shelter transactions on tax returns filed in prior years and to curtail the use of abusive tax shelter transactions in future years.[2]
- Provide for a voluntary compliance initiative permitting a taxpayer to file an amended return and pay the tax and interest associated with the abusive tax shelter transaction.
- Codify the economic substance doctrine, which is a common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction lacks economic substance or a business purpose.
- Extend the statute of limitations for taxpayers involved in abusive tax shelter transactions from four years to eight years.
- Expand the FTB's ability to issue subpoenas.
- Expand the rules to obtain a court order to enjoin abusive tax shelter transactions from being marketed within California.

A.B. 1601 similarly would increase existing tax shelter penalties and lengthen the statute of limitations for prosecution of tax evaders.

FTB and IRS Cooperation

The IRS has announced that it will ask states in August 2003 to enter into a memorandum of understanding (MOU) that would allow greater sharing of information about promoters and investors in illegal tax shelters and more cooperation in enforcement against such shelters. At a July 15, 2003 symposium on abusive tax schemes, which was sponsored in part by the FTB, Dale Hart, Commissioner of the

[1] The text of the most current versions of S.B. 614 and A.B. 1061 is available at http://www.leginfo.ca.gov/bilinfo.html.

[2] The terms "tax shelter," "reportable transaction" and "listed transaction," for example, would be defined by reference to federal *or state* income taxes as well as by transactions that are determined by the IRS *or FTB* to have a tax avoidance purpose or potential.

IRS Small Business/Self-Employed Division, stated that the MOU would enable IRS and state tax administrators to share more information sooner.

Although the IRS and state tax authorities currently may share information regarding a taxpayer, usually such sharing of information occurs at the end of an audit. The MOU, however, would provide a more systematic way to share information at the beginning of an audit or investigation. Under the MOU, the IRS would share information with state tax authorities on promoters of tax shelters and taxpayers who have invested in tax shelters. The states would share the same type of information with the IRS and perhaps other states. The IRS and the states would determine which agency should work on the case or whether both agencies would investigate.

At the July 15 symposium, Caglar Caglayan, Assistant Chief Counsel in the FTB Legal Department, described the MOU as a united front in tax agency efforts to crack down on shelters by providing the means for a very early sharing of names of investors and promoters of abusive tax schemes. Caglayan indicated that the FTB not only would be entering into the MOU with the IRS' Small Business/Self-Employed Division, but would also seek to enter into a similar MOU that would deal with mid-sized businesses with assets of more than $10 million.

Abusive Tax Schemes: FTB's View

The FTB appears to have adopted a fairly broad view as to the types of transactions that should be considered abusive tax schemes, at least with respect to state franchise and income taxes. At the July 15 symposium, Caglayan identified the following transactions as potentially abusive:

- Corporate shareholders in a regulated investment company (RIC) — the shareholders eliminate the RIC dividends from income pursuant to R&TC § 25106, even though the RIC receives a deduction for dividends paid.
- Shareholders in a real estate investment trust (REIT) with IRC § 565 consent dividends — the REIT gets a deduction for the consent dividends, but the shareholder does not include such dividends in income for California franchise and income tax purposes.
- Corporations that create or use insurance subsidiaries to shelter income by, for example, transferring the corporation's treasury functions to the insurance subsidiary.

Potential Impact on Corporate Taxpayers

Although current Congressional and IRS efforts to crack down on tax shelters are well known,[3] corporate taxpayers should keep in mind the recent legislative and administrative developments occurring in California. Taxpayers should not assume that a business transaction that is not a tax shelter or a reportable transaction for federal purposes will not be one for California purposes. First, the California Legislature is moving forward with legislation on abusive tax shelters, some of which may not entirely conform to federal legislation. Second, ordinary transactions that are not tax shelters for federal purposes could be considered by the FTB to be a tax shelter or reportable transaction for California purposes, such as those transactions cited by Caglayan above. Thus, business transactions and their impact on California franchise or income taxes need to be analyzed carefully to determine whether such transactions will be subject to California's tax shelter rules.

In addition, California's pending legislation may impact transactions offered under conditions of confidentiality. Under S.B. 614, "reportable transactions" would be defined by reference to Treasury Regulations issued under IRC § 6011 and would also include transactions determined by the FTB as having a potential for tax avoidance and evasion. Transactions under conditions of confidentiality are included in the Treasury Regulations' definition of reportable transactions, though an exception has been provided for confidentiality agreements that permit disclosures of the tax treatment and tax structure of the transaction. In light of California's pending legislation, confidentiality agreements may need to permit disclosures of the state income tax treatment and structure of a transaction to avoid treatment as a reportable

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[3] Information on IRS activity on tax shelters is available at http://www.irs.gov/businesses/corporations.

transaction for California purposes.

Furthermore, while California has taken the lead among the states in addressing abusive tax schemes, pending legislation or administrative actions in other states also should be considered when entering into business transactions. The Multistate Tax Commission (MTC) also has been involved in studying the effect of tax shelters on state tax revenues, especially from transactions involving offshore entities.[4]

Finally, under this climate of increased enforcement efforts to crack down on abusive tax shelters, corporate taxpayers undergoing an FTB audit could encounter greater challenges to their transactions. While federal tax shelter legislation and regulations target illegal or abusive tax shelters, the FTB could broaden the attack to reach even benign transactions, including transactions that happen to be affected by differences in the federal and California tax laws or involve nexus considerations such as under Public Law 86-272. Assuming that the Legislature soon will enact tax shelter legislation, focus should turn to the FTB and its proposed regulations regarding abusive tax schemes.[5]

Further Information

If you wish to obtain a more detailed explanation of California's tax shelter legislation and its ramifications, please contact Kerne H. O. Matsubara in San Francisco (415.983.1233, *kmatsubara@pillsburywinthrop.com*) or the Pillsbury Winthrop attorney with whom you work. Alternatively, feel free to contact one of the co-leaders of the Pillsbury Winthrop tax practice team, Jeffrey M. Vesely in San Francisco (415.983.1075, *jvesely@pillsburywinthrop.com*) or William L. Burke in New York (212.858.1133, *wburke@pillsburywinthrop.com*) for assistance.

[4] The text of the MTC report, Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, is available at http://www.mtc.gov/statebudgetcrisis.html.

[5] The FTB has issued a series of articles on abusive tax schemes which are available at http://www.ftb.ca.gov/education/taxnews/Index.html.